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Recent Developments in Federal Income Taxation*

The federal tax on individual incomes has been in force for almost two decades, and on corporate incomes for almost a quarter century. Consequently, it would seem that the principles to be followed in determining taxable incomes and the more important elements of gross income and deductions therefrom should by this time have been well established, not merely by statutory definition, but by administrative rulings, by Board of Tax Appeals decisions, or by judicial construction of the taxing statutes. Nevertheless, we are still having court and Board decisions handed down, and even administrative rulings made by the Treasury, which construe for the first time questions of important bearing on the determination of taxable income, or which reverse positions long held by the Treasury.

The decisions and rulings hereinafter commented on are among those of the past year—some as recently as within the past month—which are of especial interest because of dealing for the first time with an important point, or of laying down a new rule differing from views more or less generally accepted up to this time.

Basis of Assets Contributed to Partnership by Partners

A partnership is organized and the individual partners contribute property other than cash to the capital of the partnership. The value of the property when so contributed to the partnership differs from the cost of the property to the individual partners. If the partnership sells the property, what is the basis for determining gain or loss to the partnership?

The Treasury has admitted that no gain or loss is realized at the time the property is paid into the partnership. It has been contended by taxpayers' representatives that the basis of the property in the hands of the partnership is the value of the property when paid into the partnership. If this position were sustained it would permit the indefinite postponement of tax upon gains from sales since a partnership could be formed to sell property for its value at the date paid in and no tax

** Based on an address by Mr. Staub at the February meeting of the Society of Certified Public Accountants of the State of New Jersey. Mr. Davidson of our New York staff rendered valuable assistance by gathering much of the material for this address.*

would be payable until the liquidation of the partnership.

The Treasury has had this question under consideration for several years. In a ruling of the General Counsel published in January of this year it has been held that the basis of the property in the hands of the partnership is the same as the basis to the contributing partner and that any gain resulting from the sale of the property on such basis should be taxed to the partners in accordance with their distributable shares of the partnership income (G. C. M. 10092, XI-2-5349). In determining the distributable shares of the income the difference between the basis of the property to the individual partner and the value at which it is contributed to the partnership represents a gain or loss to be allocated to the partner who contributed the property. The gain or loss of the partnership based upon the value at which the property is paid in is then allocated to the partners in accordance with the terms of the partnership agreement.

Thus, if property cost A (an individual partner) $100,000 and is contributed to a partnership at a valuation of $200,000, when the property is sold by the partnership A must add $100,000 to his taxable income in addition to his share of the partnership income or loss computed on a commercial basis. Conversely, if the property is paid into the partnership at a valuation of $10,000, A is entitled to a loss of $90,000 when the property is sold, in addition to his share of the partnership income or loss on a commercial basis. Depreciation under the ruling is treated according to the same principle.

It is questionable whether this ruling properly interprets the statute. The situation would seem to be similar to that which formerly existed with respect to property acquired by corporations in a nontaxable reorganization. In such a case the tax basis to the corporation was the value of the property at the date of acquisition, and if such value exceeded the basis of the transferor the excess was not subjected to tax until it was realized by the stockholder as a part of a taxable gain resulting from the sale, liquidation or other disposition of his stock in the reorganized corporation. This situation was changed by the 1924 and subsequent revenue acts which provide that under specified circumstances property acquired by a corporation shall take the basis of the transferor rather than its value at time of acquisition. In the absence of such a requirement with respect to partnerships, it would seem that the partnership basis of property acquired by a partnership should be its value at date of acquisition by the partnership. The question will undoubtedly be carried to the Supreme Court because of its importance, and until it is finally settled taxpayers affected should properly protect their interests.

Profit From Redemption of Bonds

On November 2, 1931 the Supreme Court reversed a long line of decisions of the Board of Tax Appeals and the courts and held that when a corporation purchases and retires its own bonds at less than the issuing price, the difference represents a taxable gain, *U. S. v. Kirby Lumber Company*, 52 S.Ct.4.

The lower courts and the Board of

Tax Appeals had held to the contrary largely on the authority of the decision of the Supreme Court in *Bowers v. Kerbaugh-Empire Co.*, 271 U.S.170. In that case a taxpayer borrowed money repayable in German marks. The borrowed money was lost in the business. The value of the mark declined and the loan was repaid with less dollars than the amount borrowed. The Supreme Court held that since the transaction as a whole resulted in a loss, the apparent gain from the repayment of the marks was only a diminution of the loss and not a taxable profit.

In the Kirby Lumber case the taxpayer issued its own bonds for $12,126,800, representing their face value. In the same year the company purchased in the open market and retired some of the bonds at less than par, the difference being $137,521.30. The fact that the bonds were repurchased in the open market in the same year they were sold, and the fact that the bonds were retired made this case an excellent one for the Treasury to carry to the Supreme Court. That court found no difficulty in distinguishing the case from the Kerbaugh-Empire case on the ground that in the latter case the transaction as a whole had resulted in a loss.

The scope of the Supreme Court decision is still uncertain. If a corporation purchases its bonds for less than the issue price because it has sustained losses and is unable to pay the issue price, it may be held that the Kerbaugh-Empire case is applicable and not the Kirby Lumber Company case. Also, the Treasury regulations have always provided that gain is realized if bonds are purchased and *retired* at less than the issue price. The Treasury has in the past conceded that if the bonds were purchased and *not* retired no gain was realized. In the Kirby Lumber Co. case the bonds were retired but the Supreme Court did not refer to this fact in its decision.

Capital Gain on Stock Acquired by Exercise of Rights

For many years the Treasury held that when stock is acquired through the exercise of rights, the two-year period which determines whether the stock is a capital asset subject to the capital gain and loss provisions runs from the date the original stock was acquired and not from the date the new stock was acquired through the exercise of the rights (I.T. 1786, II-2 C.B. 45). The Treasury has reversed this ruling and now holds that the two-year period runs from the date the new stock is acquired (G.C.M. 10063, X-52-5332). The reversal of the Treasury's original position resulted from the decision of the Board of Tax Appeals in *Rodman E. Griscom v. Com.* 22 B.T.A. 979, and is probably a correct interpretation of the statute. The Treasury's original position could be justified under the statute only if the issuance of additional stock pursuant to the exercise of rights were construed to be a recapitalization and therefore a reorganization.

Expenses Connected With Nontaxable Income

In November, 1931, a ruling was issued to the effect that taxpayers could not deduct expenses of earning or collecting tax-exempt income (G. C. M.

9954-V-47-5296). This would have a serious effect upon financial houses.

The ruling resulted from a decision of a Circuit Court which held that a State officer could not deduct expenses connected with earning tax-exempt compensation, *Lewis v. Com.*, 47 Fed. (2d) 32.

After protests by taxpayers another ruling was issued in which it was held that the Circuit Court decision would be applied only to similar cases, and that taxpayers would not be prohibited from deducting expenses in connection with the derivation of income from tax-exempt bonds (G. C. M. 10123, X-52-5334). The General Counsel decided that to prohibit such deductions would probably be unconstitutional.

Basis of Property Contributed to a Corporation as Paid-in Surplus

There is an interesting question as to the basis in the hands of a corporation of property contributed to the corporation as paid-in surplus by a stockholder. The law provides that if property is transferred by gift, the basis to the recipient is the same as the basis to the transferor and also if property is transferred to an 80 per cent. controlled corporation for stock or securities of the corporation, the corporation must use the transferor's basis. Where property is contributed as paid-in surplus, it seems clear that it is not exchanged for stock or securities and the corporation could therefore be required to use the transferor's basis only if the transfer can be construed as a gift. In a recent case, *Rosenbloom Finance Corporation v. Com.*, November 12, 1931, the Board of Tax Appeals held that the transfer cannot be construed as a gift since the stockholder benefits from the increase in the value of his stock and therefore the basis of the property in the hands of the corporation is the fair market value of the property when acquired by the corporation.

This decision will undoubtedly be appealed by the Commissioner. If it is sustained and if the law is not changed, it offers a simple method of stepping-up the basis of property and accordingly deferring the payment of income taxes on gains.

Gain or Loss in Acquisition of a Corporation's Own Capital Stock

On December 19, 1930 the Board of Tax Appeals decided two important and interesting cases, *S. A. Woods Machine Company v. Com.*, 21 B.T.A. 818, and *Houston Brothers Company v. Com.*, 21 B.T.A. 804. In the latter case a corporation transferred to a stockholder property which had increased in value and received therefor 345 shares of its own stock, which it retired. The Board held that the transaction was as much an acquisition of its shares by purchase as it was a disposition of its property by sale, and that since a corporation's own shares are not assets, but only the convenient machinery for evidencing shareholder interests, it is a fallacy to say that when turned in the corporation has received anything. The Board decided no gain was realized by the corporation. Seven members of the Board dissented on the ground that the transaction was not essentially a transaction by a taxpayer

in its own stock, but was rather a sale of property. The Commissioner has acquiesced in the Houston decision.

In the Woods Machine Company case the Board's decision was even more liberal. In this case the taxpayer had a claim for unliquidated damages for patent infringement and accepted shares of its own capital stock in settlement thereof. The Board held that the corporation realized no gain on the same ground as in the Houston case, namely, that it was a transaction in the corporation's own stock. The Board said: "It is true that the book value of the remaining 1,978 shares of common stock was increased by the acquirement and cancellation of these 1,022 shares, but that added nothing to the income of the corporation. It simply caused an appreciation of value of the remaining shares of the common stock of the corporation. In this proceeding we cannot see where petitioner received anything which fits into the definition of income as approved in *Eisner v. Macomber.*" Six members of the Board dissented in this case. The Commissioner has appealed this case and it is now pending in the Circuit Court of Appeals, 1st Circuit.

Dividends Paid After Reorganization

There is an interesting question as to the status of dividends paid by a corporation resulting from a merger, consolidation or reorganization of a predecessor corporation, when the dividends exceed the actual earnings of the new corporation. The new corporation may have issued its stock in a tax-free reorganization and the predecessor corporation or corporations may have had substantial earned surpluses, which were taken over in whole or in part as capital surplus by the new corporation.

It would seem that under the law any distributions from such surplus would represent a return of capital to be applied against the basis of the stock and would not be taxable as ordinary dividends.

The Board of Tax Appeals has so held, but the Commissioner has nonacquiesced in the decision. *Irving S. Robeson v. Com.*, 18 B.T.A. 323.

Changes in Fiscal Years as Affecting Net Losses

When a corporation changes its accounting period a return must be filed for a fractional part of the year in order to effect the change. This fractional period is defined in Section 48(a) of the 1928 Revenue Act as a taxable year.

Net losses can be carried forward for two taxable years. Since the fractional period for which a return is required may be only a month or two but must be counted as a taxable year for the purpose of carrying forward losses, it is apparent that by changing its accounting period a company may be limited in carrying forward losses to 13 or 14 months instead of two full years.

This is a question which must be given consideration when a company is contemplating a change of accounting period. It may prove an effective argument against changing to a calendar

year basis in the case of a taxpayer who has previously been keeping his accounts on the basis of a year ending with some date other than December 31.

Accounting Periods of Estates

An estate which keeps books has the privilege of adopting a fiscal year instead of a calendar year, if it so desires. Many estates have found it advantageous to adopt a fiscal year other than a calendar year, so that the taxable period in which the estate taxes are deductible will include a maximum amount of taxable income against which the estate tax may be applied.

Deductibility of Payments for Agreements Not to Compete

In the case of *Eitingon-Schild Company v. Com.*, decided by the Board of Tax Appeals on January 15, 1931, 21 B.T.A. 1163, the taxpayer purchased from an individual the stocks of certain corporations which he controlled and as part of the contract of purchase agreed to pay the individual $375,000 in ten annual payments in consideration of his agreement not to compete for a period of ten years. The Board held that these annual payments of $37,500 were deductible from gross income.

Agreements of this kind are common in the acquisition of competing businesses, but very often the deduction for tax purposes is lost because the agreement is not properly worded or the mechanics of the transaction not properly arranged. Unless the tax feature is kept in mind, it is easy so to arrange the transaction that the entire amounts paid must be construed as part of the purchase price of the stock.

1931 Net Losses

Many corporations sustained larger net losses in 1931 than they will be able to absorb in the next two years. Accordingly, when preparing tax returns for the year 1931, if any deductions may be considered proper deductions for subsequent years rather than for 1931, it would be to the taxpayers' interests not to claim them in the year 1931.

Basis for Gain or Loss on Security Sales by Investment Trusts

There is a widespread impression that investment trusts, as distinguished from other taxpayers, are permitted to use average cost of securities in determining taxable gain or deductible loss on sales. The Treasury has held to the contrary in a published letter.

As in the case of other taxpayers gain or loss must be based upon the cost of the particular securities purchased and sold if they can be identified; otherwise on the rule of "first in, first out."

Even if a revenue agent accepts a return on the average basis, the basis may be rejected and additional taxes

assessed for a later year when refunds for the earlier year are statute barred.

An investment trust, just as any other taxpayer, can secure the best control over its taxable income if a record is kept of the certificate numbers of the securities purchased and sold.

It may also be mentioned that the Treasury does not permit the ordinary investment trust to inventory securities. The Board of Tax Appeals has supported the Commissioner in this position. *Adirondack Securities Corp. v. Com.,* 23 B.T.A. 61.

This question will doubtless be litigated, and it is possible that so-called investment trusts which are really active trading companies may eventually be permitted to inventory.

Entertaining Expenses, Etc.

Accountants have frequently encountered a very troublesome class of cases involving deductions for traveling and entertaining expenses, etc., when the taxpayers have no record showing the details of the amounts expended. On November 13, 1931 the Board of Tax Appeals rendered a refreshing decision in the case of *R. P. Shea v. Com.*

The taxpayer had deducted $15,000 for 1924 and $31,500 for 1925 as "sales promotion and entertainment expenses." The Commissioner disallowed the deduction as unsupported. The taxpayer testified that he spent the money, that at the time he rendered his returns he had the facts before him but had no records at the time he testified. The Board believed him and allowed the deductions in full.

Limitation on Deduction for Contributions With Reference to Capital Gains or Losses

Contributions of the character specified in the Revenue Act are deductible by individuals up to 15 per cent. of their net income. It has been the Treasury's position that in computing this limitation net income must be reduced by capital losses and may be increased by capital gains. The reduction of net income by capital losses for this purpose was covered by I.T. 2104 (III-2 C. B. 152).

On November 3, 1931 the U. S. Board of Tax Appeals decided the case of *Elkins v. Com.* and held that in determining the 15 per cent. limitation the ordinary net income need not be reduced by the capital net loss. This decision reversed the Treasury's position as stated in I. T. 2104. The decision was under the 1924 law but should be equally applicable under the later laws.

Following the decision in the Elkins case the Treasury issued Mim. 3931, dated January 27, 1932, which provides in effect that pending the result of an appeal the Treasury will protect its interests by deducting capital losses and excluding capital gains.

Since the Treasury has taken this position, taxpayers should protect their interests by including capital gains and not deducting capital losses. The courts must eventually decide the issue.

Depreciation

In February, 1931, the Treasury issued a "Preliminary Report on Depreciation Studies" representing the results of the studies conducted for five years with the cooperation of a number of trade associations and corporations. The report contains suggested depreciation rates for the various assets in a great many industries. The rates do not purport to be final or applicable to all cases and circumstances. This compilation is of suggestive value, not only in tax matters but in general accounting work.

Revenue agents have recently adopted a policy of disallowing the depreciation for the last year of the estimated useful life of a property asset on the theory that one year's depreciation is the equivalent of the salvage value thereof. This is an entirely arbitrary conclusion and where the amount involved is material such an adjustment should be contested. It is much more logical to credit to income any amounts eventually received as salvage. In many cases such salvage value as may be realized is largely offset by expenses of removal or demolition and expense of making the sale. There is also no logical reason why the salvage value of an asset with a 30-year life should be 1/30th of its cost, and the salvage value of an asset with a 5-year life 1/5th of its cost. The method is entirely too arbitrary to reflect the facts.

Carrying Charges

Since 1924 the Treasury regulations have provided that carrying charges, such as taxes on unproductive property, could be capitalized or deducted as an expense at the taxpayer's option. In March, 1931, the Circuit Court for the Fifth Circuit decided that these regulations were invalid and that taxes and interest must be deducted as an expense, *Central Real Estate Co. v. Com.*, 47 Fed. (2d) 1036. The Treasury recognized that many taxpayers had elected to capitalize carrying charges pursuant to its regulations, and that it would be an injustice to disallow such expenses as part of the cost of the property when refunds for the prior years might be barred. Accordingly, on August 6, 1931, the Treasury amended its regulations to provide that carrying charges, such as interest and taxes on unproductive property, may not be treated as chargeable to capital account unless paid or incurred prior to August 6, 1931, and not deducted in computing net income or used in determining tax liability for such prior periods. (T.D. 4321, X-33-5172).

In 379 *Madison Avenue, Inc. v. Com.*, 23 B.T.A. 29, a corporation engaged in erecting and operating an office building incurred a loss in the period before the building was ready for occupancy on account of the payment of interest, taxes, etc. The Board of Tax Appeals held that since the building was not ready for occupancy the loss was not incurred in the operation of a trade or business regularly carried on and therefore could not be carried forward to subsequent years. This seems an unnecessarily harsh decision and has been appealed.

Offsets Against Refunds Claimed

A case was carried to the Supreme Court involving the question of whether after the running of the statute of limitations on additional assessments the Commissioner could disallow deductions previously allowed, for the purpose of offsetting a refund claimed by the taxpayer. The court held that the taxpayer could not secure a refund unless he had actually overpaid the tax, even though the period of limitation had run against additional assessments, *Lewis V. Reynolds* Jan. 4, 1932).

Security Traders

When a taxpayer devotes much time to buying and selling securities and has many transactions it is frequently uncertain whether it would be to his advantage to be classified as a "trader" engaged in the business of buying and selling securities. Since the issuance of G.C.M. 9958 (X-33) which merely explains what has always been understood as existing law, revenue agents have attempted to classify many taxpayers as "traders" in order to deny them the benefit of the capital gains provisions.

Of course, even a "trader" may take advantage of the capital gains provisions if he can show that the securities were acquired for investment and not for resale in the course of his business.

Most taxpayers would benefit from a classification as "trader" under present conditions because:

1. Losses on security transactions held for resale in the business need not be treated as capital losses.
2. A trader is not subject to the wash sale provisions.
3. Net losses from trading can be carried forward to subsequent years.
4. There is a possible increase in the earned income credit.

Interest Upon Award for Condemned Property

Until recently the Treasury has held that interest on a condemnation award is exempt from tax as interest on an obligation of a state subdivision (O.D. 591, 3 C.B. 113). The Treasury has now reversed its position and holds that such interest is taxable on the ground that it is not interest on an "obligation" within the meaning of the statute and that the taxing of such income imposes no burden on a state's borrowing power (G.C.M. 10043, X-51-5324).

This interest frequently amounts to a large sum and the question will undoubtedly be litigated. The Treasury's present position is of doubtful legality. Indeed, there may even be a question as to whether any part of the *principal* of the award can be taxed on account of the constitutional prohibition against confiscation of property without just compensation. If a part of the award is taken in the form of income tax there has not been full compensation.

There is also a further question on this point as to whether or not a federal income tax on the proceeds of a condemnation award received from a state or municipality is unconstitutional

in that it imposes a burden on the instrumentality employed by a state or a subdivision thereof in the exercise of its governmental functions.

Waivers of Right to Appeal

When a revenue agent has examined a taxpayer's return and proposes additional taxes, the taxpayer is usually requested to sign a waiver of the right to appeal to the Board of Tax Appeals (form 870) if he agrees to the determination of the revenue agent. The taxpayer may contest the determination proposed by the revenue agent and reach a settlement in the office of the Revenue Agent in Charge. In this case, he is also usually requested to file a waiver of the right to appeal to the Board of Tax Appeals. Frequently, the settlements are made contingent upon the taxpayer signing such a waiver. Taxpayers have freely signed such waivers in order to secure a settlement of the case and also because the running of interest stops thirty days after the waiver is filed.

Until recently, if the Commissioner did not accept the settlement reached with the revenue agent or agent in charge, the taxes were not assessed under the waiver but the taxpayer was given an opportunity to contest any further adjustments in Washington. Recently, the Commissioner has adopted a policy of immediately assessing the tax covered by the waiver whether or not he approved the recommendation of the agent in charge. Some taxpayers have therefore been placed in a position of having reached a compromise settlement of their tax case with the agent in charge, having paid the tax pursuant to a waiver, and then being faced with an additional assessment of taxes when the Commissioner disapproves the recommendations of the agent in charge. The only way a taxpayer can prevent this situation from arising is to file a waiver with a qualification to the effect that it is effective only if the Commissioner approves the recommendation of the Revenue Agent in Charge.

Proposed Gift Tax

It has been proposed that Congress enact another gift tax to prevent avoidance of the estate tax by transfers intervivos. The Supreme Court has already held that a gift tax cannot be made retroactive to apply to gifts made before the enactment of the act. *Untermyer v. Anderson,* 276 U.S. 440. It is entirely possible under present conditions that Congress may enact such a tax. Taxpayers contemplating such gifts will therefore be well advised to make the gifts before such a tax is enacted.

Causes of Failure

An anonymous article in NATION'S BUSINESS entitled "I'm a Failure at Fifty," starts off with the following paragraph:

Two years ago I was regarded as a fairly successful manufacturer. Today, at fifty, I am broke, jobless, deeply in debt, and with nothing but a providential prayer in my heart to meet the mortgage payment on my home that is due on the first of every month.

Later, he considers his own qualifications in these words:

It might be assumed that I did not possess the qualifications necessary to success else I would not have failed, and yet a summary of my qualifications taken from the voluntary testimonials of former business associates speak of me as a man with initiative, originality, vision and energy; ability to collect facts, analyze and present them in a forcible and conclusive manner; a good advertising writer and publicity man; a spendid office executive, with a pleasing personality, resourceful, and with great capacity as an organization director; alert, vigorous, progressive, and a man with ability to put over a proposition to the public in which he believes.

He then asks the question, "To what do I ascribe the cause for my failure?" and himself answers the question with the following list of causes:

1. Lack of precaution to have an audit and appraisal made of the business into which I put my money.
2. Putting a supposed friend into a position of responsibility, in which he violated my trust.
3. Lack of sufficient operating capital, which is a chronic business disease.
4. A board of directors, whose members could not cooperate.
5. Banking connections that were fine in fair weather but unreliable when the storms came.

It is of especial interest, if not of significance, that the omission to have an audit made before investing in a business to which the writer of the article had evidently devoted himself for a period of years, is placed first among his causes of failure. He writes as follows on this point:

I realized when it was too late that if I had exercised ordinary prudence in having an audit made of the records and an appraisal of the physical assets, I would never have invested any of my money in the defunct concern.

When a concern such as mine finds itself in a financial jam, whether from overproduction or from the lack of orders, all avenues of escape seem closed. The local banks call their loans after refusing even temporary relief; the directors because of their personal indorsement on company paper become alarmed and scuttle to save themselves at the expense of the business; bond issues, as a rule, are too costly for the average business house; mortgage loan companies are exceedingly chary of loans on industrial property; and home investors are usually loaded to the hilt with the corporate stock of their various home enterprises.

Yet, despite all these deterrent influences facing the business executive who needs additional capital to insure successful operation, there is always a way out, provided the values reflected in his balance sheet are attested to be true and conservative over the signature of a reputable firm of auditors.

The writer also dilates on his lack of sufficient working capital, which he lists as the third of the causes responsible for his failure, and points out the danger of such a situation to businesses generally:

I might have overcome the loss sustained by my failure to insist on an audit and appraisal if I had squarely faced the danger of insufficient working capital and personal indorsement of the firm's paper.

A large percentage of our industries, on the authority of a prominent banker, lacks sufficient capital for successful operation. One prominent statistician says it is the cause of more failures than all other causes combined.

It has been the common practice for business organizations to build, as well as operate, on money obtained through local banks on notes bearing the personal indorsements of their officers and directors, so that in every community there is always a small group of men who carry on their shoulders, as personal liability, the entire indebtedness of the industrial activities of the community.

These bank loans, to a large extent, represent capital that has been invested in fixed assets, such as land, buildings and machinery. This class of property should be its own pledge through a financial plan that does not cramp the company's ability to make emergency operating loans in time of need, and which also does not call on a few directors and officers to stake their individual fortunes on the success or failure of the business.

If one single cog slips in this wheel of personal indorsement between the company, the banks making the loans, and the individuals indorsing the paper, catastrophe is inevitable, not only to one firm or one individual, but to many.

There is an ever existent danger for the business that depends solely on the personal indorsement of its officers and directors, for on some unforeseen day, for some cause that may now appear remote and unlikely, the business may be faced with the ultimatum of taking up its loans or being forced into liquidation.

These causes are always sudden and unexpected. Death, dissension, or financial reverses in the directorship, or the inability or the unwillingness of the banks to carry this "frozen" paper, may convert a healthy, going concern, into a grim and ghastly reminder that this practice of personal indorsement has caused you to overlook your duty to protect and safeguard your home and family.

The proper financing of industrial businesses—which the banks themselves are the first to urge, even though it cuts down the volume of loan business done with them—proceeded with rapid strides during the past decade, in part through the issuance of capital securities, especially capital stock, and in part through the pursuance of a conservative dividend policy and the devotion of a considerable portion of the annual profits to the strengthening of financial position. This has doubtless contributed to the relatively small number of failures thus far among the more important industrial concerns of the country since the 1929 crash in Wall Street.

C. P. A. Examinations

Mr. John A. Farrar, in charge of our Newark office, passed the New Jersey C.P.A. examination in November last. He is also the holder of a New York C.P.A. certificate obtained by examination some time ago.

Messrs. A. Duncan Bruce, H. J. Halliwell and F. H. Letzkus, Jr., of the staff of our Pittsburgh office, were successful in passing the recent Pennsylvania C.P.A. examination.

Mr. Hallie J. Ensign, a member of our Cleveland office staff, has received notice that he passed the Ohio examination in October, 1931.

Mr. R. L. Aiken, who joined the staff of our Portland office in January, 1929, was successful in passing the November examination in Oregon.

E. H. Bower of our Detroit staff passed the November examination in Michigan.

The L. R. B. & M. Journal

Published by Lybrand, Ross Bros. and Montgomery, for free distribution to members and employees of the firm.

The purpose of this journal is to communicate to every member of the staff and office plans and accomplishments of the firm; to provide a medium for the exchange of suggestions and ideas for improvements; to encourage and maintain a proper spirit of cooperation and interest and to help in the solution of common problems.

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In Memoriam

On October 4th last a memorial window in memory of Adam Averell Ross, one of the founders of our firm, was dedicated at the Sunday morning service in Saint Mary's Church at Ardmore, Pennsylvania. Mr. Ross had been a vestryman of that church from 1919 until his death in 1929. The window was the gift of Mr. Ross' family. The subject is the boy David caught in a moment of supplication with his face uplifted to heaven. His sheep surround his feet. On one side of the central figure is the star of David; on the other the lion, symbolic of the tribe of Judah from which David and Our Lord sprang. The following text from the 56th Psalm of David is inscribed upon the window, "What time I am afraid, I will trust in Thee." The Rector took this passage as the text of his sermon at the dedicatory service.

Retroactive Tax Legislation

The developments with respect to retroactive tax legislation during the consideration of the pending revenue bill are of especial interest to accountants because of the contribution which their profession has made to the conclusion reached by the representatives of both political parties on the Ways and Means Committee of the House of Representatives to drop the administration's plan to make the proposed increases in taxes retroactive to incomes for the year 1931.

The December, 1931, meeting of the New York State Society of Certified Public Accountants was devoted to a consideration of prospective tax legislation, plans for which had but recently been laid before Congress, and of income tax decisions and rulings during the year. Colonel Montgomery was one of the speakers of the evening, and in the course of his remarks, made the following statement:

> The proposal of the Treasury that income tax rates be increased was not unexpected, nor under existing conditions can serious objection be made to substantial increases. Taxpayers, however, are not prepared, and never will be prepared, for retroactive tax legislation. The proposal of the Treasury regarding increases in tax rates has been followed by other proposals that all losses be disallowed and other radical suggestions have been made, all to be retroactively applied.
>
> The proposal of the Treasury has been, and until settled one way or the other will be, a tremendous deterrent to a revival of business activity. The proposal itself was the big mistake. So long as people are afraid that the tax laws to which they think they are subject may be changed to take effect more than a year back, they not only will stop buying even those things which they ordinarily can afford, but they will be unwilling to embark in new enterprises. If during the early part of 1932 tax rates and other changes in the tax law are enacted retroactive to January 1, 1931, it will follow as a matter of course that during the entire year 1932 business men and all others will feel that during the session of Congress starting December, 1932, other changes may be made in the law retroactive to January 1, 1932. Consequently during the whole year 1932, when of all times in the history of the country there should be a feeling of reasonable stability so that business can go on, there will instead be a feeling of restraint and alarm because of the approval of Congress of a vicious system of retroactive tax legislation.

This statement received widespread attention and many taxpayers doubtless communicated with their Congressmen regarding the inadvisability of making the new tax rates retroactive.

On January 28th the leaders of both the Democratic and Republican organizations in the House were reported to have agreed to drop the plan for retroactive legislation. This received commendation in an editorial in *The New York Times* of the following day, the opening paragraph of which read as follows:

> Business of all kinds will read with relief the decision of the Democratic leaders in the House of Representatives to ban retroactive taxation and to balance the budget with a non-partisan levy. This announcement, made after a Ways and Means meeting yesterday, attended also by Speaker Garner, tends to confirm the growing impression that the House majority is conservative, responsible and wise. It has been a brake on the wheels of business to be in doubt whether the new imposts would refer back to 1931. New enterprises were held in check. If the Government was to reach back for a share of profits already spent, no business man would know before the end of March where he stood.

From the record thus far, it does not seem likely that the Ways and Means Committee will change its position on this question. If, however, it should do so under the pressure of the need for more revenue, the Committee will have to do it in the face of the recognized undesirability from a busi-

ness standpoint of enacting retroactive tax legislation.

Certifying in Dutch

The Associated Dry Goods Corporation, whose published annual financial statements we have been certifying for a good many years, has a considerable number of stockholders in Holland. Consequently the annual report is translated and printed in Dutch for distribution in that country. This naturally applies to our certification as well as to the balance sheet and income account. It may interest our organization to know that in Dutch we sign the certificate as "Gediplomeerde Accountants."

The writer of this note was interested to observe while in Amsterdam in 1930, that in Holland the English designation of "Accountants" is used, rather than a Dutch equivalent. This differs from the practice in Germany, Switzerland, France and other European countries where a native equivalent is used in place of the term "Accountants."

"Cost or Market, Whichever is Lower"

The stating of a principle is often much simpler than its application to a concrete case. The accountant finds this to be true in varying degrees as he endeavors to determine whether a given inventory meets the valuation test of "cost or market, whichever is lower." In many cases the ascertainment of "cost" of the articles in the inventory is relatively simple as compared with ascertaining the "market" prices for such articles.

The following note in a recent issue of *Weston's Record* brought up afresh in the writer's mind the difficulty of ascertaining "market" in applying the above-stated inventory rule:

Philadelphia Shop Fills Unusual Orders

If you really wanted to purchase a rhinoceros horn, or a circus tent, or a set of United States naval signal flags, or a stuffed pig with six legs, or a wax figure for demonstrating an appendicitis operation, or even an elephant made out of sponges, do you have the least idea where you might get them?

There is such a place in Philadelphia.

On Second Street south of Market, Benjamin Weil has conducted an old curiosity shop where things that no one apparently wants are kept in the expectation that some day some one will want them.

Take the sponge elephant for example.

When the Japanese exhibit at the sesquicentennial exposition found an elephant made of luffa, a vegetable sponge, on its hands after the exhibition, it called in Weil who added it to his collection.

How would you determine "market" —whether replacement or selling—for the contents of the establishment described above, and, in particular, how would you go about determining the "market" for an elephant made of luffa or a stuffed pig with six legs?

Although the above may seem like an extreme case, it doesn't stand entirely alone. Take a dealer in rare books, or in paintings and etchings, or other high-priced works of art. Each painting, for example, is the only one of its kind in existence and a "replacement market price" therefor in the usual sense of that term simply doesn't exist. Even the selling market price is subject to a wide fluctuation. Rare books are subject to much the same comment, even though more than one copy of a given book may be in existence. These are merely illustrations of the difficulty, and sometimes even impracticability, of fully applying in all cases the inventory rule stated as the caption of this comment.

Notes

The annual report of the Dean of the School of Business of Columbia University for the 1931 academic year includes the following statement:

We must record again our indebtedness to Colonel Montgomery who has continued his interest in the unique collection of books on accountancy which bears his name.

On February 10th Mr. Gibson addressed the Los Angeles Bank Credit Men's Association on "Audits and Audit Reports." He has since been appointed chairman of the committee of the Los Angeles Chapter of the California Society of Certified Public Accountants on cooperation with the newly formed Los Angeles Chapter of the Robert Morris Associates.

J. Marvin Haynes of our Washington office was the speaker of the evening at a recent dinner and meeting of the members of the Detroit Stock Exchange and their employees. He spoke on the subject of income taxes and many favorable comments were made on his talk.

Mr. Staub addressed the Society of Certified Public Accountants of the State of New Jersey on "Recent Developments in Federal Income Taxation," following a dinner of the Society at the Down Town Club in Newark, N. J., on February 10th. On the 25th of the month he was one of the speakers at a tax meeting in the rooms of the Accountants' Club in New York.

Governor Pinchot has appointed Mr. Marsh a member of the Pennsylvania State Board for the Examination of Public Accountants. Mr. Marsh recently delivered a vocational address over radio station WCAE, Pittsburgh, on the subject "Accountancy."

An article by Mr. Peter on "Texas Franchise Tax Returns" appeared in the Dallas *Times Herald* of January 10th. It presented the salient features of a new law recently enacted in Texas.

Mr. R. P. Ridges, until recently a valued member of our Chicago staff, and now general manager of one of our client corporations, wrote an article on "Preparation for the Coming Industrial Expansion," which appeared in a recent issue of the National Association of Cost Accountants Bulletin. It contains valuable suggestions for the manufacturer who is seeking to adapt his business and organization to present conditions and who at the same time wishes to be prepared to take full advantage of any business improvement.

Mr. Taylor has been elected one of the board of governors of the Accountants' Club, as well as assistant treasurer and a member of the executive committee of the club.

The January issue of the *Certified Public Accountant* contained an article by Mr. Warren, manager of our Cleveland office, on "Classification of Accountancy Services and Responsibility of Accountants."